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Walmart's Revenge: Amazon.com Has A Big Problem

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Amazon.com (/companies/amazon/) AMZN -9.9% (/companies/amazon/) is grabbing the headlines this week with the news that it bested rival Netflix (/companies/netflix/) NFLX -6.36% (/companies/netflix/) in securing exclusive rights to stream HBO's library of older shows (http://www.forbes.com/sites/maggiemcgrath/2014/04/23/amazon-bringing-hbo-programming-like-the-soproanos-exclusively-to-amazon-prime-members/) — such as *The Sopranos* and *Deadwood* — via its Amazon Prime streaming service.

But its streaming business, while a big headline winner, isn't the most pressing issue at hand.

It's boring, stodgy old taxes.

Amazon & HBO: That's a Victory

Snagging HBO's content was a major win for AMZN and ensures that it will remain competitive with Netflix in the battle for streaming superiority.

The benefits to holders of Amazon stock are a little less clear; the details of the deal were not disclosed, and we have no idea what Amazon paid for the content.

Both NFLX and AMZN have some degree of flexibility in raising prices to consumers; last month, Amazon raised the price of an annual Prime subscription (http://online.wsj.com/news/articles/SB10001424052702303546204579436903309411092) — which also includes free shipping on purchased goods — by $20 to $99, and this month Netflix announced it would be raising its monthly subscription cost by $1 to $2 for new subscribers (http://www.foxnews.com/entertainment/2014/04/22/netflix-poised-to-raise-subscription-prices-for-new-members/). But bidding wars for streaming rights to popular content could easily erode profitability as the streaming market starts to get saturated.

Amazon's streaming coup is getting most of the attention as the company releases its earnings (AMZN's report is due out after the bell Thursday).

But the much bigger news is the effect that sales taxes are having on the "Walmart of the Internet."

Amazon's Big Weapon Is Being Disabled

Remember, one of the biggest advantages that AMZN has enjoyed over traditional brick-and-mortar retailers like Walmart and Target (/companies/target/) TGT -0.31% (/companies/target/) is that it didn't have to collect sales taxes in the states in which it didn't have a physical presence.

In high-sales-tax states like Texas, New York and California, that is an enormous competitive advantage. In Dallas, where I live, the combined state and local sales tax rate is 8.25%. When you do the math, it means that, all else equal, everything I bought on Amazon tax-free would be 7.62% cheaper than what I would pay at a local retailer.

Given the razor-thin margins of mass-market retail, that's huge.

As consumers, we all enjoyed this tax loophole. But the state and local governments grew tired of watching their tax bases erode, and brick-and-mortar retailers got tired of seeing their customers poached by Amazon. AMZN is now required by law to collect taxes in 20 states — including the three largest by population, California, New York and Texas. More — including the fourth-largest state, Florida — are set to follow.

Within a few years, I would expect that substantially every state in the union — or at least all of those with populations large enough to matter to a nationwide retailer — will be collecting sales taxes from Amazon and other online retailers.

The effect on Amazon and holders of Amazon stock is crystal clear: It's bad.

A study by the National Bureau of Economic Research (http://papers.nber.org/tmp/51204-w20052.pdf) published this month found that households in the states that had already implemented the online sales tax reduced their purchases at Amazon by 9.5%, and the impact was greater for higher-priced items.

Interestingly, Amazon's loss is Main Street's gain; these same states saw a 2% increase in sales at brick-and-mortar stores.

Call it Walmart's revenge.

Is Amazon Stock Really Worth It?

What does this mean for investors in Amazon stock?

It should be a major red flag. Amazon is a fine company, and I have nothing but respect for founder and CEO Jeff Bezos (http://www.forbes.com/profile/jeff-bezos/). He's one of the great business innovators of our age. But the current price of Amazon stock — even after its recent 24% decline — makes some assumptions about growth that are a little hard to swallow.

Stock	Ticker	ROA	ROE	P/E Trailing	P/E Forward	Price/Sales
Amazon.com	AMZN	1.28%	3.06%	553.07	76.65	2.03
Walmart	WMT	8.24%	20.05%	16.09	13.55	0.53
Target	TGT	5.80%	12.02%	19.78	12.71	0.53

It also reflects Amazon's willingness to accept lower margins today as a means of building market share; presumably, once its competitors are crushed, AMZN will have freer rein to raise prices and boost margins.AMZN has never really made money; its return on assets and return on equity are some of the lowest among major retailers. To the bulls, Amazon's low profitability is perfectly acceptable — a result of the massive depreciation charges that come with Amazon's massive capital expenditures in building out its business empire.

Maybe.

But look at the valuations being awarded for this hypothetical future growth. Using the price/sales ratio as an equalizer that is not distorted by Amazon's high depreciation charges, we see that Amazon stock is nearly four times as expensive as WMT and TGT.

I agree that Amazon stock should probably trade at a premium to Walmart and Target given its faster growth and its diversification into areas such as e-readers, cloud storage and other non-traditional retail areas. But a premium of *four times*? This would seem to completely ignore Walmart and Target's massive infrastructure advantages and both companies' own online efforts.

My recommendation? Short Amazon and go long WMT and TGT.

Charles Lewis Sizemore, CFA, is the editor of Macro Trend Investor (http://macrotrendinvestor.investorplace.com/) *and chief investment officer of the investment firm Sizemore Capital* *Management (http://www.forbes.com/management/)*. ***Click here*** (https://order.investorplace.com/index.jsp?sid=OA8336) (https://order.investorplace.com/index.jsp?sid=OA8332%0d)*to receive his FREE weekly e-letter covering top market insights, trends, and the best stocks and* *ETFs (http://www.forbes.com/etfs/)* *to profit from today's best global value plays. This article first appeared on* InvestorPlace *(http://investorplace.com/2014/04/amzn-amazon-stock-sales-tax)*.

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